

TO: Files

CC: San Diego Audit Committee

FROM: Willkie Farr & Gallagher LLP

RE: Interview of John Kaheny on May 11, 2006

DATED: May 18, 2006

On May 11, 2006, Sharon Blaskey, Michael Shapiro, and Benito Romano (for a brief period) in Willkie Farr & Gallagher LLP's capacity as counsel to the Audit Committee, interviewed John Kaheny, former Assistant City Attorney for the City of San Diego, at the City Administration Building, 202 C Street in San Diego, in a conference room on the third floor. Donielle Evans from KPMG also attended the interview. Mr. Kaheny was not represented by counsel.

The following memorandum reflects my thoughts, impressions, and opinions regarding our meeting with John Kaheny, and constitutes protected attorney work product. It is not, nor is it intended to be, a substantially verbatim record of the interview.

Warnings

Ms. Blaskey began the interview by explaining the circumstances and purpose of the City of San Diego's (the "City") creation of the Audit Committee, noting that information obtained during the course of the interview would be used, if relevant, in the Audit Committee's eventual report. Ms. Blaskey explained that Willkie does not represent Mr. Kaheny and, thus, statements made during the interview are not covered by the attorney-client privilege. Nonetheless, we would be treating the information obtained during the interview as confidential, covered by the work-product privilege during the investigation, but any such privilege would likely be lost with the release of the Audit Committee's report. Ms. Blaskey asked that Mr. Kaheny keep the interview confidential. Ms. Blaskey further explained that, if requested, we would provide information from the interview to the SEC, the U.S. Attorney's Office or the City's outside auditor, KPMG, so it is important that Mr. Kaheny be accurate and truthful. Ms. Blaskey emphasized that Mr. Kaheny should seek clarification of any question at any time.

Background

Mr. Kaheny stated that he joined the City Attorney's Office in March 1974 and became a deputy in June 1974. He was a criminal prosecutor for four years and then worked in the Civil Division where he practiced general municipal law and represented the police on labor issues until 1989. In 1982, the City's labor lawyer died, so he also became legal counsel for labor relations, working closely with Jack McGrory, who was the senior representative of the management team for labor relations at that time. In 1989, he became Chief Deputy and was involved in public affairs, including personnel issues. As Chief Deputy, he supervised the police

legal advisors and was staff to the police review boards and the Civil Service Commission. In August 1991, he became the Assistant City Attorney. As Assistant City Attorney, he was the "managing partner" of the City Attorney's Office and handled all classified staff and issues. He was the administrative supervisor over the Criminal and Civil Divisions. All chief deputies reported to him. He retired from the City of San Diego in November 1996, and then became the City Attorney for the City of Chula Vista for six and a half years, until March 2003.

Ms. Blaskey asked Mr. Kaheny to describe his involvement in labor issues. He said he was generally involved with SDCERS regarding "415 tax issues." He stated that Lori Chapin was assigned to him but was on loan to SDCERS. Sharon Marshall took over labor relations completely from Lori Chapin and reported to him. Marshall dealt with meet and confer issues, as well as personnel situations.

City Budget Problems

Ms. Blaskey asked Mr. Kaheny to describe the budget problems that were affecting San Diego when he was an employee. Mr. Kaheny recalled that in 1992, City Manager Jack McGrory received direction from the Mayor and Council that he should cut 10% of the budget but that there should be no layoffs, public safety should not be cut, and the Enterprise Funds should not be tapped. McGrory used budgetary devices to avoid layoffs including voluntary leave, deferring maintenance, and reducing the number of City attorneys. Mr. Kaheny said that one "budgetary trick" involved having one attorney working on both trash and fire issues but paying for that attorney through the trash budget. McGrory had to "patch this, patch that" to cut the budget and the City was really strapped, so McGrory had the attorneys fill gaps even if they were paid for by other program areas. Mr. Kaheny assumes other departments were also required to work this way. He said that McGrory did a "pretty good job" at "holding the tide back" and the City was able to make it through the bad economic times. He noted that in 1992, Judie Italiano, President of the Municipal Employees Association ("MEA"), was asked by McGrory to give up two weeks of salary of her employees, which amounted to \$500,000. At the same time, McGrory awarded the Arts Commission \$400,000. Mr. Kaheny said that these kinds of budget tactics were common.

Mr. Kaheny said that from 1994-1996, there were serious budget problems in San Diego because the biotech industry left the City. The Council again wanted to avoid layoffs. In 1996, the Republican Convention came to San Diego, and McGrory told all departments that they would have to "eat" their overtime. As a result, salary savings were used to cover overtime. "Comp time" increased and was carried over to the following year, which caused budgetary problems the following year. Ms. Blaskey asked if the Convention was a plus or minus on the overall economy. Mr. Kaheny said it was a plus.

Mr. Kaheny did not advise the Council on budgeting issues, but he did provide advice regarding legal aspects of ideas that the Council brought to his attention. For example, he advised on liability issues and Brown Act requirements regarding ideas proposed by Council. He did not advise regarding budgeting itself.

The City Manager and Budgeting

Ms. Blaskey asked Mr. Kaheny to describe the role of the City Manager in the budgeting process. Mr. Kaheny responded that the City Managers kept some money hidden away to protect themselves because "anything can happen when budget meetings start." A budget for a City is "not like one for a normal business" because there is a "political override." He said that the City Manager was told to find the money necessary to run the City and was under pressure to do so. Mr. Kaheny stated that the City Manager always had to have a trick to find money. He noted that "eventually the system catches up with you," and gave the example of needing a new fire truck if the City saved money by failing to put oil in the old one. McGrory "would try to keep the Council under control" regarding spending but was "always facing five votes." Ms. Blaskey asked Mr. Kaheny to explain what he meant by the City Manager was "always facing five votes." He said that it used to be that candidates for Council ran City-wide if they lost in the primary. When the City went to solely district elections, "eight fiefdoms" were created. Elected officials then traded votes to get things for their districts. The Mayor did not have a vote and the Mayor was the only City-wide elected official. The Mayor's power was personal not institutional. This created a dynamic where there was a shifting 5-0 majority vote on the Council. Large long-term City projects that did not impact the whole City were not funded because a majority of the Council did not live where those projects were proposed. The City Manager had to convince a "floating five vote majority" to support his plans.

SDCERS and Interaction with the City

Mr. Kaheny responded that he does not remember anything before late 1995 regarding reduced contribution rates. He said that up until 1993, Jack Katz was a representative on the SDCERS Board and that Katz came up with the idea to increase benefits. MP1 was the first benefit increase of the 1990's.

Earnings Stabilization Reserve

Mr. Kaheny was shown Exhibit 1, a May 9, 1995 letter from Morrison & Foerster to Lawrence Grissom re: "Opinion on Transfer From Earnings Stabilization Reserve." Ms. Blaskey asked Mr. Kaheny to explain the issue. He responded that the Council had told McGrory to do more in terms of equal opportunity, especially in the police and fire departments and to "get rid of the old boy network." McGrory came up with the idea of having employees retire early, which would also save money. McGrory discussed the idea with SDCERS and worked with SDCERS to find a way to make early retirement more appealing. Ms. Blaskey asked Mr. Kaheny to explain a Rate Stabilization Reserve. He responded that if the formulas in the retirement system were changed and people retired early, the actuarial data was no longer valid and it would go up or down. McGrory asked to have a Rate Stabilization Reserve established for one year to test his theory that money would be saved by having employees retire early. Mr. Kaheny said that McGrory and Ed Ryan (City Auditor and Comptroller) dealt with the Rate Stabilization Reserve. Mr. Kaheny volunteered that he is a conservative guy and had a bad feeling about using the retirement system for social change. He said "don't fiddle with it."

The Funded Ratio

Ms. Blaskey asked Mr. Kaheny to discuss his knowledge of the funded ratio. Mr. Kaheny responded that in 1995, the market was coming back and the City was approaching a 100% funded level. There are tax consequences for going beyond 100% funding. Ryan and McGrory were concerned about the effect of those tax consequences. Mr. Kaheny explained that you can only make tax deferred contributions to the system to a certain level under IRS Section 415 and if you exceed what is necessary to fund a benefit, there is no reason for the government to allow tax deferral. The City had to go to Congressman Matsui to get an exception to Section 415. Mr. Kaheny stated that if the City exceeded a 100% funded level, no contributions to the system would be allowed on a tax deferred basis so the take-home paychecks of employees would decrease. The 100% rule and the Section 415 issue became Mr. Kaheny's assignment.

Mr. Kaheny volunteered that meanwhile, Jack Katz (a SDCERS Board member) proposed ideas to the SDCERS Board to increase retirement benefits, but did not know of the tax consequences. As a result, discussions began that led to MP1.

SDCERS Counsel

Mr. Kaheny was shown Exhibit 2, an April 23, 1996 letter from John Witt to SDCERS regarding conflicts of interest. Ms. Blaskey asked Mr. Kaheny to explain the document. Mr. Kaheny responded that in February or March 1996, Chapin said that MP1 would be negotiated and the City needed to "get Witt out of it" because he had a conflict. Witt recused himself, as well as the City Attorney's Office. He noted that Witt was extremely ethical. Mr. Kaheny said that Witt felt that if the management team was going to the unions and discussing raising benefits that could affect the City Attorney's Office, the City Attorney's Office had a duty to bow out. Ms. Blaskey asked Mr. Kaheny whether Lori Chapin was SDCERS independent counsel at this time. Mr. Kaheny said that Chapin was not yet independent, but there was a "Chinese Wall." He said the issue of her independence arose around 1996 because SDCERS was a separate legal entity for purposes of legal action. Proposition 187 sets forth the fiduciary standards for public employee boards. Chapin felt that SDCERS needed independent counsel. Witt was opposed and felt an informal "Chinese Wall" was appropriate. Mr. Kaheny said he favored a formal "Chinese Wall." As of April 1996, there had been no formal resolution to the issue.

Need for Fiduciary Counsel on MPI

Ms. Blaskey asked Mr. Kaheny why the City needed fiduciary counsel for MP1. He said that the issues fiduciary counsel examined were not necessarily related to the fiduciary responsibilities of SDCERS. Fiduciary counsel was hired because McGrory wanted good legal advice.

MPI

Mr. Kaheny was shown Exhibit 3, a final version of MP1. Ms. Blaskey asked Mr. Kaheny to explain McGrory's reasoning behind MP1. He said that McGrory's theory was that if there was an increase in the contribution factors, people would retire faster, which would save the City money. Mr. Kaheny referred to page 3 of Exhibit 3 and pointed out that people could

leave San Diego at age 55 with similar retirement benefits as if they left at age 61. He noted that Witt would have a contribution factor of 2.47 instead of 2.31 if he left after MP1 was approved.

Mr. Kaheny's Role in MP1

Ms. Blaskey asked Mr. Kaheny to describe his role in MP1. He responded that he helped train Marshall and went to SDCERS Board meetings. He did not do legal work or analysis because of the City Attorney's recusal. He noted that Jeffrey Leavitt provided counsel regarding the legal ramifications of MP1. If Kaheny provided any legal advice regarding MP1, it would be in writing.

Mr. Kaheny was shown Exhibit 4, May 2, 1996 minutes of the SDCERS Retirement Board of Administration Special Meeting. Ms. Blaskey asked Mr. Kaheny to describe his role at this meeting. He responded that he did not take an active role but simply "tagged along." He did not like McGrory going anywhere without him because McGrory "had a tendency to let the egg roll off the table." He explained that McGrory was a "running back" and "did not cut over to the edges often" but that McGrory "took off quickly," thought quickly, and "was off to the races." Mr. Kaheny attended meetings such as the one discussed in the minutes so that he would know what McGrory was doing and so that he could be there for him if he needed advice.

Mr. Kaheny responded that he did not do research on MP1 and relied on outside counsel and Chapin to do it. Ms. Blaskey asked Mr. Kaheny if he had any concerns about MP1. He said that the sole function of the pension system was to provide benefits and should not have been used as a tool for personnel management, including McGrory's early retirement plan. Mr. Kaheny felt he may have told McGrory his opinion.

Role of SDCERS in MP1

Ms. Blaskey asked Mr. Kaheny to explain the role of SDCERS in MP1. He said that McGrory tried to get SDCERS to buy into MP1. McGrory also felt it helped politically in selling MP1 to the Council if SDCERS was on board with it. Mr. Kaheny volunteered that Section 11.1 of the Charter prohibited the Council from delegating responsibility for spending money to anyone. He concluded that SDCERS did not need to vote on MP1 because when the Council approved MP1 it was a "done deal" even before SDCERS approved it. He said the Council's duty is non-delegable. Mr. Kaheny told McGrory that SDCERS did not need to approve it but suggested that MP1 be discussed with SDCERS in Closed Session since McGrory needed to know if the unions could handle the impact of MP1. He said SDCERS was briefed in Closed Session but he did not think SDCERS voted on MP1.

Ms. Blaskey asked Mr. Kaheny why SDCERS replaced the law firm of Morrison & Foerster with Hamilton Faatz. He did not recall. Ms. Blaskey asked Mr. Kaheny if any pressure was placed on SDCERS to approve MP1. He said no. He vaguely recalled that Ryan had concerns. He noted that Ryan fought with McGrory "all the time." Ms. Blaskey asked Mr. Kaheny whether any SDCERS Board member received direct pressure by McGrory. He did not recall. He noted that McGrory "can be very persuasive," but no management appointees complained to Kaheny about any kind of pressure.

Ms. Blaskey asked Mr. Kaheny if he recalled discussions with anyone regarding whether it was proper to have the SDCERS Board vote on MP1. He said he had no recollection of any conversations about it. Mr. Kaheny noted that he recalled the involvement of SDCERS as akin to "an agreement not to sue" and as "an insurance policy." He said he had a gut feeling and told McGrory that it was not a great idea to sell a retirement increase for non-retirement reasons. Mr. Kaheny noted that a retirement increase was proper if the reason was to alleviate the possibility of reaching 100%+ funding.

Mr. Kaheny's Reaction to MP1

Ms. Blaskey asked Mr. Kaheny to describe his reaction to MP1. Mr. Kaheny responded that the concept of getting the SDCERS Board to agree on MP1 was a disaster. McGrory's personality was one of "always trying to cut a good deal." He noted that McGrory did not want opposition from the SDCERS Board. McGrory did the best he could to bring SDCERS into the process. Mr. Kaheny stated that had MP1 not been put in place, the SDCERS Board could have issued a writ for payment. Mr. Kaheny further noted that, from the SDCERS Board's perspective, MP1 represented a covenant not to sue.

Fiduciary Duties

Mr. Kaheny was shown Exhibit 5, an April 29, 1996 letter from Jeffrey Leavitt to Bruce Herring re: "Fiduciary Aspects of Plan Revisions." Ms. Blaskey asked Mr. Kaheny why the City had Leavitt opine on SDCERS Board members' fiduciary duties. He could not remember, but noted that Leavitt reported to Herring. Mr. Kaheny thought that maybe fiduciary counsel was asked to render an opinion because the City Manager's Office appointed people to the SDCERS Board and therefore, there was an issue of "multiple hats." He said that there may have been questions about whether the appointed members represented management on the Board. Mr. Kaheny noted that it is not uncommon for management and unions to have seats on pension boards. Ms. Blaskey asked Mr. Kaheny to describe the role of management appointees on SDCERS. Mr. Kaheny responded that he was pretty sure he was never asked to opine on the dual roles served by management appointees. He stated that Herring was McGrory's alter ego and that Connie Jamison (an SDCERS Board member) was a "tough cookie." He said he "can't see McGrory putting pressure on her." Mr. Kaheny noted that Jamison was "a strong personality."

Ms. Blaskey asked Mr. Kaheny to describe the role of John Casey on the SDCERS Board. He responded that Casey was "a character" and had concerns "over anything brought up." Mr. Kaheny noted that Casey was closely aligned with Ron Saathoff (SDCERS Board member and Local 145 Representative) but, on MP1, appeared not to agree with Saathoff.

MP2

Ms. Blaskey asked Mr. Kaheny to describe his reaction to MP2. He responded that in 1996, the City "left the campsite" but in 2002, the City "got lost in the woods." He said the trigger provision implemented in 1996 was recognized again in 2002, but "with no sophistication" on the latter occasion. He noted that McGrory honestly believed that the funding level would not go below 85% and that McGrory did not have a mischievous plan.

Saathoff Side Deal

Mr. Kaheny volunteered that in 1994, Herring cut a deal with Saathoff through a side letter. Ms. Blaskey asked Mr. Kaheny to explain this side deal in greater detail. Mr. Kaheny responded that in 1993, Saathoff was working in the fire station. In 1994, the personnel director, Rich Snapper, and Ed Ryan came to him and told him that Saathoff was being carried on the payroll at the fire station but was never there. Mr. Kaheny was shown a letter from Herring to Saathoff providing him with City pay but allowing him to work full time as union president. An investigation was launched and Saathoff hired an attorney who filed a writ and argued that "a deal is a deal." Girard argued the writ on behalf of the City. The Judge told the City it had to stick by the deal. The City Attorney's Office wanted to appeal and discussed this in Closed Session, but the Council voted not to appeal.

Ms. Blaskey asked Mr. Kaheny why Herring made the side agreement with Saathoff. He responded that Herring did it to come to agreement. He said that as a result of the side agreement, "the firefighters went along with the MOU." Herring had a "get a deal mentality" and did not want the Council to know about the side deal. Mr. Kaheny said that the City Attorney's Office had no knowledge of the side deal. He noted that Saathoff was "one smart cookie" but "went a bridge too far."

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